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Economic Report

December 1989

Commentary on Pertinent Economic Issues

Economic Forecast For 1990

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Chief Economist

The end of a year traditionally brings forth efforts to divine the future, in order that individuals and businesses plan for the coming twelve months. The end of a decade finds people augmenting this thought process by looking back to see if any lessons can be learned which will help them see the forest for the trees. Comparing where we are today with where we were ten years ago, one finds, of course, many differences—but one important similarity, namely, prosperity.

Ten years ago, the United States economy was in the process of logging in the longest peacetime expansion in recorded history. The economy began to grow in April 1975, after 16 months of recession, and continued to expand for a record-breaking 58 months—through January 1980. That was not only twice as long as the average peacetime upswing—it was also longer than *any* other expansion recorded to date except for the 80-month upturn that encompassed World War II, and the 106-month boom that included the Vietnam War.

Not surprisingly, both business and labor shared in this advance. The jobless rate fell from a postwar high of nine percent to 5½ percent, while the number of people working rose by over 17 percent. Corporate profits, always extremely sensitive to changes in economic conditions, more than doubled over this period.

By these aggregate measures, prosperity once more reigns across the land. Last month marked the 84th month of expansion in overall economic activity—two years longer than the upswing of the late 1970s, and now the second longest in history. Unemployment is once more in the five percent zone, employment has jumped by 19 percent, while corporate profits have expanded by more than 50 percent.

To be sure, there are a number of differences, the most important of which deals with inflation. In the late 1970s, the economy was clearly overheating. Prices were soaring at double-digit rates, with both consumer and producer prices climbing by 15 percent. Interest rates were rising as the Federal Reserve tried to cool things off, but they lagged behind the rate of inflation, producing negative real interest rates, and no disincentive to borrow.

Today, inflation is much more subdued. Aside from the fact that oil prices—the major reason for the inflation of the 1970s—have come down, the economy underwent two recessions earlier in this decade, plus a number of other price-stabilizing developments (Economic Report—August 1989). And real interest rates are not only positive, but are today well above their historical norms, as the Fed has gotten out ahead of inflation by reining in the growth of money and credit.

This brings me to an evaluation of the current economic scene. In a word, it is confusing. Rare is the time when forecasting is easy, but this juncture seems more difficult than most because of the plethora of conflicting information that dots the business picture. To put it another way, there is good news and bad news out there, and the question is which—if either—will ultimately prevail.

Some Good News

Since it is fashionable nowadays to disparage the state of the economy, it might be useful to begin with the good news. Perhaps the best piece of news to come down the pike in a long time is the recent relaxation of tensions between East and West. Aside from its obvious implications for world peace, it has a significant bearing on the business outlook. For one thing, it opens up new markets for American industry. For another, it will create new investment opportunities. And, of course, it will lead to a drop in defense spending on top of that which has already occurred.

This actual and anticipated decline in defense outlays is of no small importance. First it opens up an opportunity for Washington to reduce its budget deficit by cutting spending in an area that affects only a small portion of the overall economy—yet is a big chunk of Federal spending. This alone will help to lower interest rates as Washington's borrowing requirements decline. Keep in mind also that military spending tends to be inflationary, since people are paid to produce goods that do not become available for domestic consumption, so a reduction in these outlays will also curb inflation pressures. Plainly, less inflation will also lead to lower interest rates.

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On the subject of interest rates, they have come down. Short rates are now more than two points below their spring highs, while long-term yields are off by less than 1½ points. This has reversed the negative, or inverted yield curve, in which short-term interest rates climb above long-term rates. Short rates will rise above long yields when the Fed becomes very tight with the supply of money and credit. Although not every instance of a negatively-sloped yield curve has led to a recession, every recession in at least the past 30 years has been preceded by the appearance of such an inverted curve. The curve did go negative last December, but only slightly, and has been positive, on balance, since mid-October, indicating at least a modest loosening of the Fed's grip.

One of the major unnoticed positive elements in the economic outlook is the absence of unwanted inventories. With the exception of some retailers—particularly automobile dealers—stocks throughout most of the economy appear to be in good shape. The manufacturing sector has one of its lowest ratios of inventories to sales of this decade, while wholesalers' stocks are well below recession highs. Credit the widespread use of computers, just-in-time inventory management, and a willingness to reduce orders and output at the first sign of sluggishness with keeping inventories down. In turn, this should help the economy avoid the shock that massive inventory liquidation usually brings.

Another plus is the high level of employment. Thanks to the growing number of jobs in the service sector, total employment is at a record level and the jobless rate is very close to its low point for the cycle. More jobs obviously produce more confidence—not to mention more buying power, so although consumer spending is not booming, it is still climbing even after subtracting the effects of inflation.

Speaking of increased spending, it is impossible to ignore the huge orders placed for aircraft by the world's airlines over the past two years. The major U.S. aircraft producers, Boeing and McDonnell Douglas, have enough planes on order to keep their assembly lines—and those of their suppliers—humming for years. Besides helping local economies, this influx of orders offers an opportunity for many defense contractors and sub-contractors to keep their assembly lines humming—if they can make the transition from military to civilian methods of production and cost control.

This is not to suggest that there will not be much government work in the offing. On the contrary, the need to rebuild the nation's highways, bridges, tunnels and other public facilities has been obvious for some time—and is already being tackled, judging by the amount of construction one encounters as one travels around the country. Add to this the expected infusion of Federal money to help the Southeast repair the damage caused by Hurricane Hugo, and the West Coast rebuild from the earthquake, and you have plenty of business for the nation's construction firms. Let's not forget also the ongoing efforts to clean up the environment by curbing pollution and recycling waste, as an added source of business.

Some Bad News

To be sure, there are some negatives as well. New domestic car sales rose 6½ percent in 1988, reaching 7½ million units. After a shaky start, they moved higher this year, reaching an 8⅓ million unit clip by August. However, that was fueled by deep discounts and the threat of a big price increase on the 1990s; sales fell in September and October, and by early November reached one of the lowest selling rates since the 1981-82 recession. Detroit has responded by slashing production schedules and laying off workers.

Homebuilding has been declining for a longer period of time, indicating deeper-rooted problems. Although new-home starts rose during the mid-1980s from their recession lows, they have since fallen back and are currently no higher than levels first reached almost 40 years ago. The reasons are many, but they include high interest rates, prices that have gone up much faster than family incomes, and in-

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	< Actual			Projected >
	1989			
	1	2	3	4
Gross National Product	5113.1	5201.7	5278.9	5325.8
GNP: $82	4106.8	4132.5	4160.2	4157.5
% Change, Annual Rates	3.7	2.5	2.7	-0.3
Consumption $82	2641.0	2653.7	2694.1	2670.7
Durables $82	419.3	424.9	438.3	411.1
Non-Durables $82	915.0	909.7	922.5	924.1
Services $82	1306.7	1319.0	1333.3	1335.5
Investment $82	721.1	719.8	723.6	739.1
Non-Residential $82	501.0	511.4	517.2	514.4
Producers Durable Equip. $82	379.9	393.2	397.5	394.8
Structures $82	121.1	118.1	119.7	119.5
Residential $82	195.6	189.3	185.2	189.2
Inventory Changes $82	24.5	19.1	21.2	35.6
Net Exports $82	-55.0	-51.2	-63.6	-68.5
Exports $82	569.7	587.5	589.8	586.1
Imports $82	624.6	638.7	653.4	654.6
Government Purchases $82	799.7	810.3	806.0	816.3
Federal Defense $82	254.4	255.8	260.4	254.5
Federal Civilian $82	81.1	87.8	76.1	90.9
State & Local $82	464.2	466.7	469.4	470.9
Final Sales: $82	4082.3	4113.4	4139.0	4122.0
% Change, Annual Rates	3.1	3.1	2.5	-1.6
Domestic Demand: $82	4161.8	4183.7	4223.8	4226.0
% Change, Annual Rates	1.8	2.1	3.9	0.2
Final Dom. Private Demand $82	3337.6	3354.3	3396.6	3374.2
% Change, Annual Rates	2.3	2.0	5.1	-2.6
GNP Price Index (1982 = 100)	124.5	125.9	126.9	128.1
% Change, Annual Rates	4.0	4.6	3.2	3.8
Consumer Price Index (82-84 = 100)	121.9	123.8	124.6	125.5
% Change, Annual Rates	5.4	6.4	2.4	3.0
Total Personal Income	4317.8	4400.3	4457.5	4528.5
Disposable Personal Income	3689.5	3747.7	3808.4	3864.1
Savings Rate	5.6	5.3	5.0	5.7
Unemployment Rate	5.2	5.3	5.2	5.5
Indus. Production (1977 = 100)	140.7	141.7	142.2	141.9
Housing Starts (000)	1517.3	1352.0	1339.0	1322.7
Domestic Auto Sales (000)	6915.0	7327.7	7867.7	6060.4
Dom. Auto & Lt. Truck Sales (000)	11523.0	11982.8	12767.7	10860.4
Corporate Pre-Tax Profits	318.0	296.0	272.0	250.2
Net Profits	173.6	161.1	149.5	138.1
Net Cash Flow	388.6	391.7	396.7	366.2

creased restrictions imposed by localities on developers.

When housing suffers, many other industries do, too. Besides reduced demand for labor and construction materials, fewer homes built mean fewer sales of household furnishings, such as furniture, fixtures and home appliances. In turn, this tends to hold back consumer spending in general, since people are less apt to be in stores. You can see where the ripple effect here is even greater than with automobiles.

Turning to foreign trade, exports stopped growing around midyear, sending the trade deficit soaring in the third quarter, as measured in the GNP accounts. On a monthly basis, the trade deficit in September retreated to its lowest level in nearly five years—but mainly because of a drop in imports. With the dollar well above its early 1988 lows (and overvalued against many currencies), it is fairly obvious that the decline in imports is more a sign of greater domestic weakness, than of increased domestic competitiveness.

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YEAR 1989		1990				YEAR 1990	
LEVEL	% CH	1	2	3	4	LEVEL	% CH
229.9	7.2	5364.8	5407.1	5460.2	5530.1	5440.6	4.0
139.3	2.9	4152.3	4152.9	4158.6	4176.8	4160.2	0.5
2.9		-0.5	0.1	0.6	1.8	0.5	
664.9	2.6	2679.1	2693.5	2702.5	2718.3	2698.3	1.3
423.4	2.4	411.4	413.6	415.2	419.6	415.0	-2.0
917.8	1.5	927.0	930.2	933.2	937.5	932.0	1.5
323.6	3.4	1340.7	1349.7	1354.0	1361.2	1351.4	2.1
725.9	1.4	716.4	706.7	702.7	703.0	707.2	-2.6
511.0	3.5	508.0	502.6	497.0	493.1	500.2	-2.1
391.4	5.3	390.2	387.2	383.0	379.8	385.0	-1.6
119.6	-2.1	117.8	115.4	114.0	113.3	115.1	-3.7
189.8	-2.2	184.8	182.9	183.6	189.3	185.2	-2.4
25.1		23.5	21.2	22.1	20.6	21.9	
-59.6		-60.4	-65.5	-69.3	-70.7	-66.5	
583.3	10.0	580.3	575.0	573.9	579.1	577.1	-1.1
642.8	6.3	640.7	640.6	643.2	649.8	643.6	0.1
808.1	2.9	817.3	818.2	822.7	826.2	821.1	1.6
256.3	-2.0	252.4	246.5	244.2	238.8	245.5	-4.2
84.0	24.6	91.1	94.6	96.6	97.4	94.9	13.0
467.8	2.5	473.9	477.2	482.0	490.0	480.7	2.8
114.2	2.9	4128.8	4131.7	4136.5	4156.2	4138.3	0.6
2.9		0.7	0.3	0.5	1.9	0.6	
198.8	2.4	4212.7	4218.4	4227.9	4247.5	4226.6	0.7
2.4		-1.3	0.5	0.9	1.9	0.7	
365.7	2.4	3371.9	3379.0	3383.1	3400.7	3383.7	0.5
2.4		-0.3	0.8	0.5	2.1	0.5	
126.3	4.2	129.2	130.2	131.3	132.4	130.8	3.5
4.2		3.5	3.1	3.4	3.4	3.5	
124.0	4.7	126.4	127.3	128.3	129.6	127.9	3.2
4.7		3.0	3.0	3.1	4.0	3.2	
426.0	8.9	4578.4	4636.5	4689.7	4764.2	4667.2	5.4
777.4	8.6	3904.4	3955.3	4001.6	4065.3	3981.7	5.4
5.4		5.4	5.1	5.0	5.0	5.1	
5.3		5.9	6.1	6.3	6.4	6.2	
141.6	3.2	140.5	140.1	139.8	140.5	140.2	-1.0
382.8	-7.5	1217.7	1247.4	1366.0	1416.1	1311.8	-5.1
042.7	-6.7	5949.4	5848.3	5896.3	6094.2	5947.0	-15.6
783.5	-5.2	10749.4	10548.3	10596.3	10894.2	10697.0	-9.2
284.0	-7.4	225.4	225.4	230.1	250.3	232.8	-18.0
155.6	-7.9	124.2	124.2	127.2	138.1	128.4	-17.5
385.8	-4.0	328.2	328.5	336.6	363.8	339.3	-12.1

You will recall I pointed out before that service employment has helped keep total employment up. The flip side of this is that employment in the goods-producing industries—especially in manufacturing—has begun to decline. Indeed, factory payrolls fell for seven months in a row between March and October. Output of goods is now falling; the Federal Reserve's index of industrial production is down over the past three months—the first such decline in more than three years. Even production of business equipment, previously a bright spot, stopped expanding around midyear; it has fallen in three of the past four months and now stands at its lowest level since February.

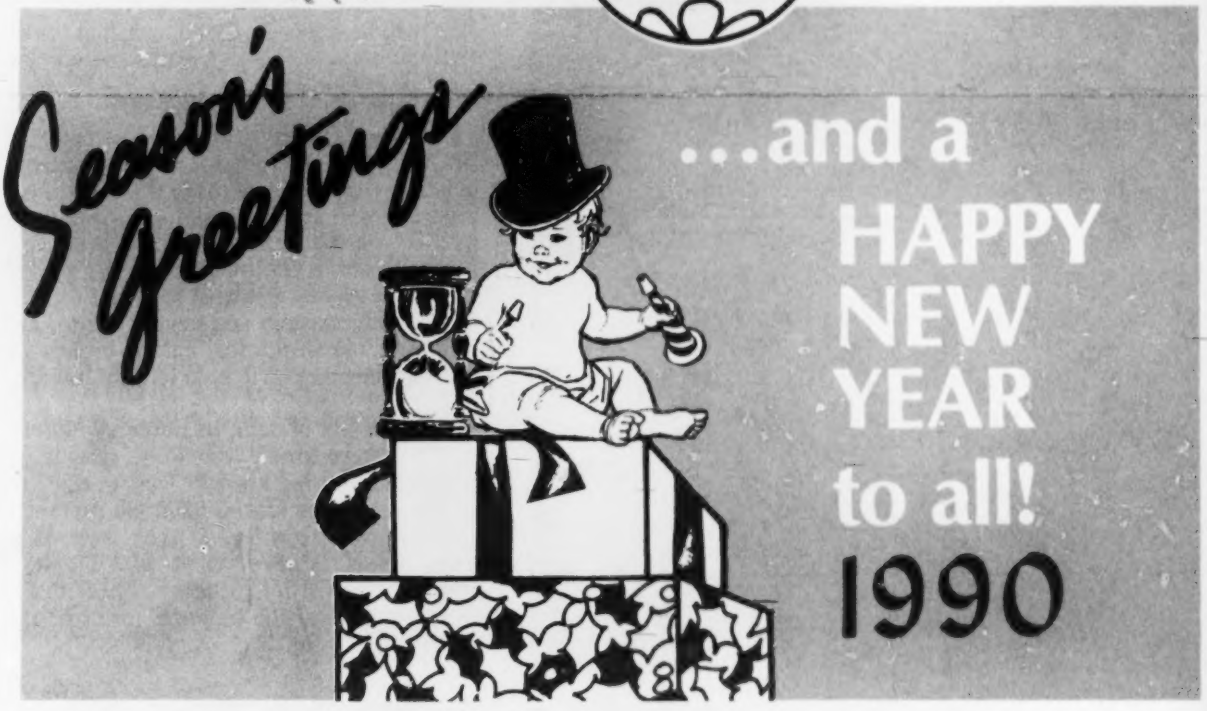
One reason for this drop might be the decline in corporate profits registered so far this year. It obviously reflects the softness in many segments of the economy, which is preventing businesses from generating enough unit volume to boost profits—not to mention keeping them from passing along higher costs in the form of higher prices. Lower profits mean less money available to spend on new machinery and equipment, research and development—and, of course, additions to the workforce. Fal'ing profits also make it more difficult for business to bear its debt burden.

On the subject of debt, its burden would be lighter if interest rates were lower. And while rates have come down, as noted above, they are still high in real terms, as was also pointed out. One reason might be that the Fed is still being comparatively tight-fisted. Bank reserves have been falling all this year, as have the broader measures of the money supply, adjusted for inflation. These developments in the past have pushed the economy into recession because of inadequate liquidity.

It's Up To The Fed

At this point, the pluses are in the process of being outweighed by the minuses. To prevent this from becoming a full-fledged slump, the Fed will have to ease further, allowing the money supply to grow, and interest rates to fall. If nothing else, this is needed to keep the stock market from tumbling. Although the events that took place on Friday, October 13 were not precisely anticipated, the October issue of this Report did conclude with a warning that stocks were vulnerable to a decline. That they fell as swiftly as they did on the 13th, and on one or two days afterward, is a signal that the Fed should not overlook: The market is reflecting increasingly deteriorating economic conditions.

Managing the economy has been almost exclusively the province of monetary policy since the beginning of this decade. The fast-moving events in Eastern Europe now provide room for fiscal policy to help via cuts in defense spending. In turn, this should give the Fed confidence that it can ease without triggering a new round of inflation. On the assumption that the Fed will ease, our economic forecast for 1990, presented in the table to the left, calls for a pause in the expansion—but no full-blown recession. ■



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Economic Report

MANUFACTURERS HANOVER

Economic Report

February 1990

Commentary on Pertinent Economic Issues

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Monetary Policy Dilemmas

The story of the U.S. economy is becoming more and more like a soap opera. Almost every day a statistic is released or an event occurs that shifts prevailing opinion one way or another. And in this day of worldwide electronic linkups and instant news dissemination—not to mention the internationalization of money flows and the increasing interdependence of national economies—these attitudinal changes are immediately reflected in a wide variety of financial market instruments. Interest rates in the bond and money markets have become increasingly volatile, as have foreign exchange rates, stock prices, and prices of precious metals, oil and many key commodities. In turn, these signals have begun to influence policymakers around the world—especially central banks, where reactions can be relatively swift.

Back home, our central bank, the Federal Reserve, has been preoccupied with trying to achieve price stability in a constantly-changing environment. The Fed has not tried to keep monetary policy on "automatic pilot," fearing that wide swings in the "real" economy might result. Yet, it apparently has concluded that it cannot ignore trends in the monetary aggregates—the various measures of the money supply—for they seem to have at least long-run significance. This has produced a rather eclectic monetary policy, dominated by no one indicator, but rather, by many. While such a policy has enabled the Fed to be more responsive to current economic needs and market concerns, it has heightened the need for the central bank to be able to filter out signals from noise—no small task in this era of confusing statistics and constant revisions.

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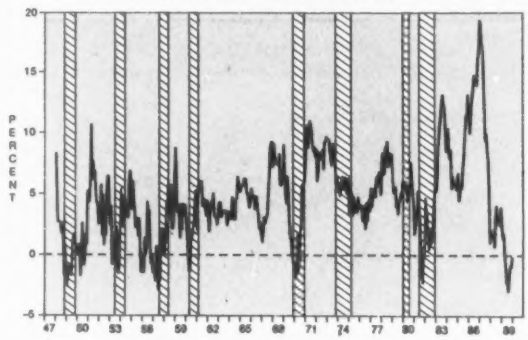
The Fed Has Eased—Barely

Over the past year, the Fed has shifted the focus of monetary policy from progressive restraint to somewhat less restraint. Although the key Federal funds rate has fallen by about 1½ points since last April, and the two narrower measures of the money supply, M1 and M2, have grown fairly rapidly since the middle of last year, the broader measure, M3, continues to grow only slowly, while total bank reserves (adjusted for reserve requirements) are no higher than they were a year ago—after plunging by the steepest year-over-year rate in the postwar era last summer (Chart I). What is more, the markets have begun to suspect that this is about as easy as the Fed is going to get—at least for now.

CHART I
TOTAL BANK RESERVES
ADJUSTED FOR RESERVE REQUIREMENTS
(12-MONTH PERCENT CHANGE)



Source: Federal Reserve Bank of St. Louis

To be sure, some market participants would not be unhappy if the Fed were to call a halt to its 10-month policy of allowing short-term interest rates to decline. They point to the rate of inflation—which last year worsened both at the consumer and at the producer level, reminding us that this is not in keeping with the Fed's stated goal of achieving price stability within a few years. And while prices of many industrial raw materials did fall last year, labor costs—whether measured in terms of total compensation, or in costs per unit of output, rose faster last year than the year before.

These participants have registered their displeasure over the prospects for additional Fed ease by selling bonds. As a consequence, yields on long-term bonds have climbed sharply in recent weeks. After touching a 2¾-year low of 7.83 percent in the middle of December, yields on the bellwether 30-year Treasury bond climbed to 8.55 percent six weeks later. However, before the Federal Reserve concludes that it should not ease further, it should take into account two points: (1) A lot of this selling has been by foreigners, principally the Japanese, reacting to conditions in their own markets; (2) The U.S. economy is undeniably weak and could get weaker, still.

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Since the first element is neither likely to be long lasting, nor under the control of our monetary authorities, it is more useful to examine the second. There is no denying that the U.S. economy ended 1989 on a soft note. The real gross national product in last year's fourth quarter rose only 0.5 percent at an annual rate—the slowest quarterly rise since second-quarter 1986. Then, it was the weakness in the Oil Patch, overlaid on what was a two-year slump in manufacturing because of the dollar's earlier strength that pulled the overall GNP down.

This time, the decline appears to be more broadly based: Consumer spending fell, production of autos and most other durable goods (with the notable exception of commercial aircraft) declined, while homebuilding sank to its lowest levels since the 1981-82 recession. In addition, exports, which had been a source of strength in 1987 and 1988 (following the decline in the dollar between February 1985 and early 1988), stopped growing in the middle of 1989 (reflecting the dollar's subsequent rebound). Not surprisingly, factory payrolls have fallen for nine straight months—the longest such decline since 1986, when they were down eleven months in a row.

Let's not forget fiscal policy. Although Washington's eight-year string of 12-digit budget deficits has shifted fiscal policy into stimulative overdrive, the deficit is now getting smaller both in relative as well as in absolute terms. What is more, it could become even less stimulative, if the Administration's plan to trim defense spending comes to fruition and is not offset by increases in outlays in the nondefense sector and/or by tax cuts. It might be stretching things a bit to worry about fiscal policy becoming too restrictive at this stage—especially when a smaller deficit would entail less borrowing by Washington, and thus lower interest rates—but it is something that bears watching. Moreover, other countries have tightened up their economic policies, which could slow our economy further by reducing the demand for our exports.

The reluctance with which the Fed has eased monetary policy since last April, not to mention the statements attributed to several Fed governors that further easing is unnecessary because the economy has passed through the worst of the slowdown and the present rate of inflation remains "unacceptable," suggests that the monetary authorities have a great deal of confidence in their ability to manage the U.S. economy—moreso than may actually be the case. It may be true that monetary policy can be used effectively to restrain the economy, but it does not necessarily follow that monetary policy alone can stimulate activity, when such a move is called for.

Pushing On A String

This was the situation in the 1930s, you may recall. At that time, the U.S. economy was spiraling downward, in what was to be known as the Great Depression. Recognizing that it had tightened money when it should have loosened, the Fed proceeded to flood the banking system with reserves, in the hopes of driving interest rates down low enough to stimulate the borrowing necessary to increase spending. Rates came down all right, but the banks refused to lend and people were reluctant to borrow. This gave rise to the expression, "You can't push on a string."

In many respects, we are in the same circumstances today. The deflation of many asset values, such as real estate, along with the huge debt loads now being borne by consumers and corporations and the contraction of the "junk" bond market, has begun to affect attitudes toward credit on the part of both borrowers and lenders. Those who in the past might have been counted on to borrow at the first sign of easier money and lower interest rates are more reluctant this time around.

Both individuals and corporations are currently shouldering record levels of debt. Total consumer debt outstanding as a percent of take-home pay now amounts to nearly 80 percent, up from 60 percent seven years ago, and the highest in postwar history. For their part America's nonfinancial corporations now have to set aside 43 cents out of every cash flow dollar just to service existing debt. This, too, is the highest in the postwar era—and twice the level of just four years ago.

Lenders, naturally, have become more reluctant to extend credit. Many banks and savings and loans have experienced increased problem loans, thus their lending standards have tightened. In some cases, they are refusing to make loans at all even under the most conservative conditions. The commercial banks in particular have been under pressure from their regulators to boost their capital ratios, and one quick way to accomplish this is to shrink the size of their balance sheets—in other words, to make fewer loans and investments.

In this regard, the Fed's ability to receive the correct economic feedback from the banking system may have been altered. As was pointed out last year (Economic Report—August 1989), one of the Fed's key intermediate target variables in the past few years may have misled the central bank into thinking that it was easier than it actually was. Because of their reluctance to lend, the banks did not borrow from the Fed's discount window as much as the widening gap between the discount rate and the Federal funds rate suggested they should have. Thus the Fed continued to drain reserves from the banking system, pushing the funds rate up sharply in 1988 and early last year until signs of economic softening became too obvious for the Fed to ignore. The banks are still staying away from the discount window—but this does not necessarily mean that monetary policy is all that easy.

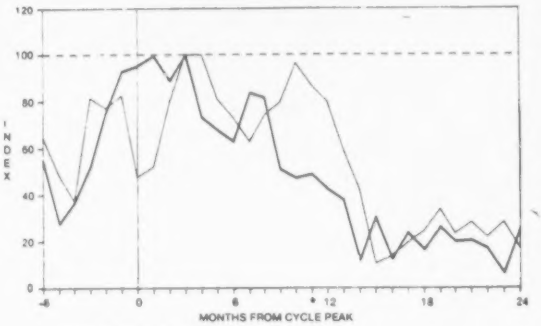
Aside from this, there are other changes one hopes the Fed is aware of. A good part of the weakness in the economy today can be traced to the (mis)fortunes of our two key industries, autos and housing. While lower interest rates and easier financing terms won't hurt, they may not help, either. This is because prices of both new cars and new homes have soared faster than family incomes, making these purchases largely unaffordable to all but a few.

For example, back in 1973, the average family had to work only 17½ weeks to make enough money to buy the average car; today it's over 25 weeks—and this is with more people working per family! Housing is no better. Twenty years ago, the average home cost 2.4 times the average family's income; today it's nearly four times more. Carmakers in particular have encouraged consumers to borrow for longer periods of time in order to enable them to bring their monthly payments back into line with their incomes—but this has had the effect of keeping people out of the market for a new car that much longer.

Braking Inflation Is Hard To Do

If the Fed is waiting for inflation to slow *before* easing monetary policy, it should be aware of the past and the present. A lot of today's inflation is outside the control of monetary policy. For example, December's record cold wave caused prices of energy and foods to shoot up. Oil prices are also determined by decisions made by the oil-producing nations—again outside the purview of the central bank. On the wage side, a large chunk of today's rise in worker compensation traces to factors that have little—if anything—to do with labor's bargaining power. These include the higher costs of Social Security taxes and medical care. As for the past, the record shows that most of the reduction in a given rate of inflation will occur *after* the economy has gone through a recession, and in the first year or two of recovery that follows (Chart II).

CHART II
AVERAGE OF 8 POSTWAR RECESSIONS:
3-MONTH PERCENT CHANGE IN CPI (THICK) VS.
3-MONTH PERCENT CHANGE IN PPI (THIN)
<CPI & PPI PEAKS=100>



*Length of average recession
Sources: Bureau of Labor Statistics; MH

On the other hand, the Fed's freedom to reduce interest rates may be constrained by the very interdependence of national economies and internationalization of money flows referred to at the beginning of this Report. If U.S. interest rates go down too far too fast, they might cause investors from other countries, on whom we have grown increasingly dependent, to dump their holdings of Treasury securities and seek higher returns elsewhere. Given the tighter monetary policies that other central banks are pursuing, this would not be a difficult search. Ironically, this would cause rates on U.S. Government securities to move up, unless the Fed stepped in and bought them, in which case, it would lead to an even easier policy. In the meantime, the dollar would probably fall, helping exports—but at the expense of rekindling inflation from higher-priced imports.

Thus the saga of the U.S. economy goes on, with businessmen, economists and the markets watching to see what the star of the show, the Federal Reserve, will do next. Will monetary policy stabilize, ease—or tighten? Even more important, will the results be what the Fed expects them to be?

Stay tuned. ■

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MANUFACTURERS HANOVER

Economic Report

April 1990

Commentary on Pertinent Economic Issues

Inflation: What's The Beef?

Irwin L. Kellner
Chief Economist

Although it is too soon to say for certain that the United States economy has dodged another bullet and avoided a recession, the financial markets have already begun to exhort the Federal Reserve to tighten monetary policy, because they fear an acceleration of inflation. Having missed the turn a year ago (Economic Report—April 1989), when they also thought they saw developing inflationary pressures—only to be blindsided by the effects tight money was exerting on the economy—these Fed-watchers may be too far *ahead* of events, this time around.

To be sure, the economy has managed to pull out of the power dive it went into at the beginning of last October. However, if prices of industrial raw materials—which signaled this plunge as soon as it began—are any guide, all that has happened is that the economy has stabilized at a slower pace of activity than it was running at last summer (Chart I). While this may be the "soft landing" that the Fed has supposedly been seeking, it doesn't necessarily mean that the worst is over—not to mention that tighter money is now de rigueur.

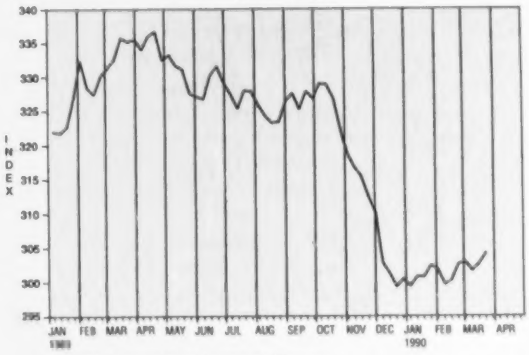
A Hard Landing For Profits

For one thing, major sectors and regions of the economy are still gasping for air. Manufacturing is weak, with output of the nation's factories, mines and utilities up less than one percent over the past year. Construction is depressed; housing starts are barely above last year's levels, while business expenditures on factories, office buildings, shopping centers, warehouses, and the like, were no higher at the start of this year, after adjusting for inflation, than they were 16 years earlier! Exports, the prop under business activity from late-1987 through mid-1989, have slowed. And to top it off, corporate profits are spiraling downward.

This development in particular should stay the hand of the central bank, making it think twice before tightening money and boosting interest rates. For you see, profits are the grease that turns the wheels of American industry. If business makes less, it stands to reason it will have less to spend on materials and supplies, plant and equipment, research and development—and, of course, on labor.

Take capital spending, for example. Chart II shows what happens to business fixed investment when cash flow—which is obviously derived from profits—declines. The same may be said for other types of business outlays, upon which much economic activity depends. To underline their importance to the economy, the quarterly profits data were part of the Commerce Department's index of leading economic indicators until recently. They were dropped when the series was converted to include monthly data only—not because they were no longer considered a reliable business indicator.

CHART I
TUESDAY SPOT PRICE INDEX: RAW INDUSTRIALS
(1967=100)



Source: Commodity Research Bureau

Plainly, profits are falling because many companies face weak markets. This means, of course, that their sales are down, causing per-unit costs to rise. Yet, the soft demand they face prevents them from raising selling prices enough to offset these higher costs. The ratio of prices to unit labor costs is at its lowest point in seven years, as are profit margins. If companies are having trouble raising selling prices to cover their increases in costs—not to mention to widen margins—it is difficult to see where the inflation threat is coming from.

Looking further, one finds not inflation, but deflation at the commodity level. Prices of industrial raw materials are clearly below last year's levels, as you saw in Chart I. At the next stage, producer prices for crude goods less food and energy have been falling, year-over-year since

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last November, and are now 6½ percent below a year ago—the biggest 12-month decline since 1985. As a result, producer prices for goods at the intermediate level, excluding food and energy, are no higher than they were last year at this time—after having been up by as much as 7½ percent yearly in the summer of 1988. As for finished goods, they are rising by the slowest yearly rate since the autumn of 1988; in June of 1989 they were up by the most for any 12-month period in almost seven years.

These trends have percolated up to the consumer. If one looks at consumer prices excluding food and energy—the so-called "core," or underlying rate of inflation most affected by the state of the economy—one finds that they are rising by about 4½ percent, year-over-year, less than last year at this time, and not far from the rate posted during the past five years. This means that most prices the consumer has to pay are rising at the same rate they've been climbing at since the end of 1984—not price stability, but no cause for alarm, either.

But the evidence is not confined to domestic markets. Prices of goods we import are going up much more slowly, too. Because the dollar has climbed against many currencies over the past couple of years, imports' prices have slowed their rate of rise to less than two percent, year-over-year. By contrast, back in the spring of 1987, these prices were shooting up at a yearly rate of nearly 12 percent! Of course, we're paying for this improvement with the flattening in exports noted above, but you can't have everything.

CONSUMER PRICE INDEX: 12-MONTH PERCENT CHANGES
TOTAL, GOODS & SELECTED SERVICES

	Feb. 1983	Feb. 1984	Feb. 1985	Feb. 1986	Feb. 1987	Feb. 1988	Feb. 1989	Feb. 1990
TOTAL	3.5	4.7	3.6	3.1	2.2	3.8	4.8	5.3
Total Goods	2.8	4.4	2.1	1.2	0.2	3.4	4.7	5.4
Total Services	4.3	4.8	5.2	5.3	4.2	4.4	4.9	5.1
Home Maintenance Services	4.0	7.3	3.8	4.1	0.7	4.8	1.7	3.9
Housekeeping	2.5	2.8	2.8	3.3	1.8	1.6	4.7	1.4
Dry Cleaning	5.6	5.8	5.0	4.3	3.5	4.8	5.8	3.8
Auto Maintenance	5.9	3.5	3.2	3.1	3.8	3.9	4.8	3.5
Medical Care Services	11.5	6.1	5.1	7.3	7.3	6.1	7.2	8.4
Physicians' Fees	8.2	7.5	5.2	6.7	7.8	7.3	7.6	6.5
Dentists' Fees	6.2	8.8	6.5	5.5	6.2	7.3	6.3	6.6
Entertainment Services	6.4	4.8	5.3	5.8	4.3	4.7	5.3	6.2
Personal Care Services	5.6	3.2	4.8	4.0	2.8	3.8	4.5	5.2
Educational Services	11.1	9.5	9.9	8.4	8.1	8.0	7.6	7.8

Source: Bureau of Labor Statistics

The astute reader has no doubt noticed that most of the price indexes I have referred to so far are those which exclude food and energy. While it is true that neither are determined by the state of the economy—thus controllable by monetary policy—the fact remains that both are an integral part of budgets for businessmen and consumers. Thus it should be acknowledged that both have risen sharply of late, due to December's record cold wave that gripped most of the nation. But what the weather does, it can undo; January and February were extremely mild. Thus oil prices in spot markets have already retreated to pre-cold wave levels, sending producer prices of energy down five percent in February and gasoline in particular down more than two percent. And while food commodities are still climbing, they have risen only moderately from their 1989 low points—and are far below levels reached in the middle of 1988, when drought fears were at their worst.

People Run Faster To Stay Even

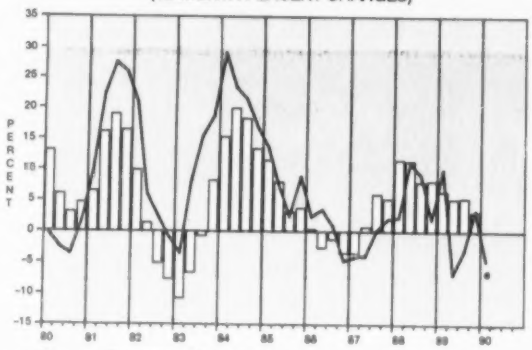
Most inflation bears would probably agree with this analysis, but would also point to the strength in employment as a harbinger of future trouble on the inflation front. This is because of two factors that may be derived from strong labor markets—big wage increases (which drive up costs), and large income gains (which boost potential demand). Thus, one should examine the state of the labor market to see if the ongoing rise in employment is, indeed, inflationary.

There is no denying that payroll employment has grown respectably—if not spectacularly—throughout this record-breaking business expansion. However, there is little reason for concern. First of all, growth has clearly slowed as business conditions have softened. Second, the payroll figures, as noted in the April 1989 Report, don't distinguish between single- and multiple-jobholders. The Labor Dept. reported later that year that the proportion of people holding down more than one job in 1989 was the highest in three decades! Is this inflationary, or is this merely an effort to keep pace with such expenses as rising Social Security taxes at the Federal level, and soaring property and sales taxes at the state and local level?

Ironically, the more people are trying to stay even with taxes, the harder they must run. Although nonfarm payrolls are nearly 25 percent larger today than they were at the end of the last recession, buying power of the average worker's earnings is actually two percent *lower*!

This reflects the fact that most of the job growth in this expansion has been in services, where wages are relatively low, as opposed to goods, which usually pay more. Indeed, if one goes back ten years, to the start of the 1980s, one finds that goods payrolls are actually three percent lower now; all of the payroll growth and then some has come in the service sector.

CHART II
NONFINANCIAL CORPORATE NET CASH FLOW
PUSHED FORWARD 1 QTR. (LINE)
VS. NONRESIDENTIAL FIXED INVESTMENT (BARS)
(12-MONTH PERCENT CHANGES)



Source: Commerce Department

Let's turn to labor costs. It may be true that unit labor costs are on the rise. Year-over-year, unit labor costs are now up by five percent—well above the postwar average of four percent, and the most for any 12-month period since the last recession. However, this is not so much a sign of a booming economy, as one that is soft, since as observed above, declining sales are preventing companies from spreading their costs over enough units of output. Indeed, over the past 30 years, unit labor costs rose the fastest while the economy was either in a recession—or about to enter one.

There is another reason why labor costs are climbing—and it doesn't have anything to do with the state of the labor market. Since the fourth quarter of 1987 a growing chunk of businesses' labor expense has occurred because of the rising cost of fringe benefits, namely Social Security taxes, the cost of medical care and reimbursement for education. Indeed, these latter two have for years risen at least twice as fast as the overall consumer price index, as the accompanying table plainly indicates.

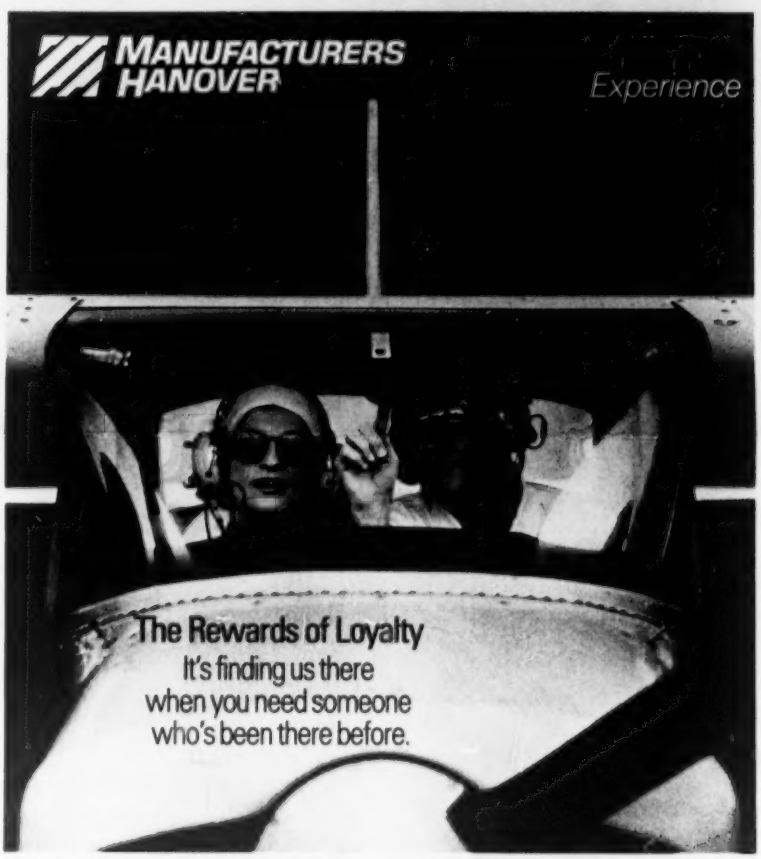
Policy Is Restraining Inflation

In the final analysis, inflation needs fuel to jump. Such fuel takes the form of rapid growth in the supply of money and credit. As has been pointed out time and again, inflation may have any one of a number of direct causes (wars, the weather, labor disputes, oil price hikes, a drop in the dollar's external value, etc.) which might boost prices of certain products or services temporarily. However, for these price hikes to become embedded in the overall price structure there must be excess liquidity. Absent rapid money growth, price increases in one sector of the economy would have to be compensated for by price cuts elsewhere, leaving the overall price level unchanged, for the most part.

Economists agree that money growth should not be more than is necessary to allow for some expansion in economic activity, plus a modest rate of inflation. Over the past year, the real GNP has gone up by 2.5 percent, while the GNP price index has risen 3.7 percent, for a total of 6.2 percent. Yet, during this same period, the broadest measure of the money supply, M-3, is up by only about three percent. This is not only not enough to fuel accelerating inflation— it may not even be enough to allow for economic growth.

The Fed is probably trying to compensate for the push the economy is still receiving from Washington's budget deficit. However, the deficit has fallen relative to the GNP—even after taking into account its partial masking by the mandatory purchases of Treasury securities by the Social Security and other trust funds. In particular, defense spending is falling—not only relative to the economy, but in absolute terms as well. Inflation-adjusted defense outlays, as measured in the Government's national income accounts, were four percent lower at the end of last year than they were two years earlier. Compared with the GNP, defense spending is now back to 1982 levels.

This is no small boost for inflation-fighters. For in the past, peak periods of inflation have coincided with rapid defense buildups. It's not hard to figure out why. Spending on defense-related items increases the demand for raw materials, productive capacity, and labor, without a corresponding increase in the availability of goods that occurs when the Government spends for nondefense purposes. Since defense spending was declining well before the relaxation of tensions between East and West became apparent, it is sure to fall even further in the months and years ahead, providing more assistance in the battle against inflation.



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Economic Report

June 1990

Commentary on Pertinent Economic Issues

Irwin L. Kellner
Chief Economist

The Rules Of The Game

One of the things that fascinates me about economics is that it is a constantly-changing discipline. The rules that govern economic behavior don't always work the same way. For example, there are times when people will step up their buying when they see prices beginning to rise more rapidly than before, while there are other occasions when consumers will hold back, hoping for prices to fall. Businessmen are no different. Sometimes they will spend more, even though their sales and profits are falling, while other times they will trim their outlays in the same setting. The challenge to economists, of course, is to figure out beforehand whether the rules are working—and in which way.

One Singular Sensation

One thing economists could depend on, however, was economic policy. As sure as the sun rises in the east and sets in the west, monetary and fiscal policy could be counted on to tighten up when the economy got overheated, and loosen when business was slipping. Tighter money, of course, would mean a reduced availability of money and credit and higher interest rates. On the fiscal side, tightness would involve some combination of tax increases and spending cuts. An easier monetary policy would see the Federal Reserve expanding the supply of money and credit, in the process lowering interest rates, while a more relaxed fiscal policy, of course, meant more spending and/or tax cuts.

What is more, these policies could be relied on to operate in tandem. In other words—when tightness was called for, both monetary and fiscal policy would tighten; the opposite would occur when the economy needed a lift. The results of these changes in economic policy were comparatively easy to predict: Less money at a higher cost, combined with reduced spendable incomes, invariably caused consumers and businessmen to retrench, thereby slowing economic activity and cooling off inflation. More money in circulation, lower interest rates, and increased incomes due to more spending by Washington and/or lower taxes would lead to more spending, hence a pickup from whatever softness might have existed.

Gradually over the postwar years, the workings of economic policy began to change. More and more of the burden of managing the economy was placed on the shoulders of the Federal Reserve, since fiscal policy became less and less flexible. This was because fiscal policy became increasingly politicized as elected officials got in the habit of promising the electorate more than there were revenues to pay. Deficits in Washington's budget became the rule, rather than the exception, as was the case in the prewar era. In the past 30 years, there have been only two in which Washington's budget was *not* in deficit, the last one being 1969!

This two-decade string of deficits alone did not render fiscal policy inoperative. It is theoretically possible for the economy to be just as restrained from a sharp reduction in a budget deficit as from an actual surplus; it depends on how much government spending is cut and/or revenues raised. The problem is—even a shrinkage in the deficit has been hard to come by. Indeed, after averaging $2 billion, or 0.4 percent of GNP in the 1950s, Washington's budget deficit rose to $6 billion, 0.8 percent of GNP in the 1960s, $35 billion, 2.1 percent of GNP in the 1970s—and $157 billion, 4.1 percent of GNP in the 1980s.

Policy Split Caused Some Surprises

With policy becoming more and more one-sided, it was little wonder that many economists' analyses and forecasts came a cropper. For example, many thought the huge budget deficit that developed in 1982 in the wake of the Economic Recovery Tax Act of 1981 would stimulate the economy. Indeed, that was its purpose: To push the economy fast enough so that the resulting increase in government tax revenues would be sufficient to balance Washington's budget within a few years, without the need to make major spending cuts. This was not an unreasonable assumption, since traditional analysis first offered by John Maynard Keynes suggested that Federal deficits stimulate the economy by adding to aggregate demand.

But here was the first major instance where fiscal policy did not work in tandem with monetary policy. The Federal Reserve was actively fighting inflation in this period. It did so by restricting money growth: In the first half of 1982 the money supply was flat, and by the middle of

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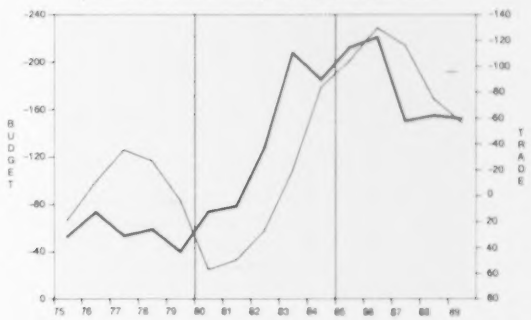
that year was only about six percent higher than it was 15 months earlier. On the other hand, budget deficits must be financed, and bigger budget deficits require more Federal borrowing. Washington always gets first claim on the nation's financial resources. So, with the backdrop of reduced credit availability and a low domestic savings rate, Washington's greater financings resulted in less funds left for the private sector—business and consumers—along with comparatively high interest rates. In retrospect, it is not too difficult to see why the economy in 1982 was not only not stimulated by the burgeoning budget deficit—it was actually held back by it.

CHART I
REPORTED FEDERAL BUDGET DEFICIT (THICK) VS
REAL NET EXPORTS, NIA BASIS (THIN)
(BILLIONS OF DOLLARS) <INVERTED SCALES>



Sources: Treasury Department; Commerce Department

In this "test of wills" between tighter money and an easier fiscal policy, monetary policy won. The result was one of the longest and deepest recessions of the postwar era, which came to an end only after the Federal Reserve eased its grip and allowed more money and credit to flow into the economy, thus lowering interest rates to the point where private sector borrowing could resume. Unfortunately, the economic recovery did little to narrow the now 12-digit budget deficit. As a consequence, other side effects began to appear.

Deficit Aftershocks Rattle Goods Producers

For one thing, Washington's borrowing needs continued to escalate. This was necessary to finance not only each year's deficit, but to refinance previous deficits, as well as numerous off-budget activities, sponsored enterprises and loan guarantees. This had the effect of keeping interest rates relatively high, especially when adjusted for inflation. In turn, this inhibited those industries that rely on the availability of low-cost credit such as construction, household furnishings, and automobiles. The number of residential dwelling units constructed in 1985, for example, was 26 percent fewer than it was 13 years earlier—notwithstanding a 52 percent jump in the age group that buys the most homes, the 25-34 year olds. As for autos, Detroit sold 15 percent fewer cars in 1985 than it did a dozen years earlier.

But that's not all. Washington's budget deficits soon began crowding out the entire goods producing sector of the U.S. economy. It did this—not by pulling money away directly, but by creating conditions such that goods producers didn't need to borrow the funds. Of course, I am referring to another big deficit that developed—the one in our foreign trade (Chart I). It arose because the dollar nearly doubled in value between July 1980 and February 1985, as foreign investors sold their currencies and bought dollars in order to partake of our high interest rates. Needless to say, U.S. exporters saw their sales slump, while those domestic businessmen who competed with goods produced abroad found their market share diminishing as well.

Meanwhile, back home, the Government's interest expense began rising rapidly, the result of years of accumulated deficits. This should not have been surprising, even though the budget deficit had been shrinking relative to the GNP since 1983. Washington's debt outstanding tripled during the 1980s, and now stands at 55 percent of GNP—the highest in nearly 30 years (Chart II). The average interest rate that Washington must pay to service this debt is now 8.9 percent, compared with three percent in 1961, when the government's debt last was this size relative to the economy, and less than one percent in 1946, when the debt was over 25 percent larger than the GNP.

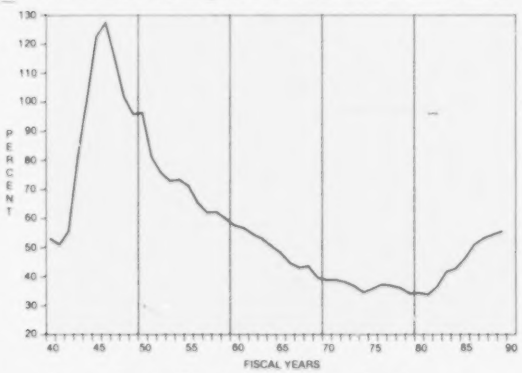
Several years ago, Washington's annual interest expense exceeded *all* outlays for such programs as grants to state and local governments, foreign aid, housing assistance, student financial aid, veterans' medical care, plus the cost of government-sponsored research. In 1988, these interest outlays about equalled Washington's *total* budget deficit. This year they could exceed it by at least $20 billion, as the share of Federal

spending that must be devoted to servicing Washington's debt has become the largest in history.

The True Burden Is Spending

All this talk of the budget deficit might lead the reader to think that this is the only way one measures the burden of running the government. Not so. The true burden of government is measured by how much it spends, not by how these expenditures are financed. For Washington does not have money of its own to spend; it must tap one or both of two sources—taxing and borrowing—to obtain the funds it needs. As you can imagine, both involve the private sector giving up purchasing power to the public sector.

CHART II
TOTAL FEDERAL DEBT OUTSTANDING AS A PERCENT OF GNP



Sources: Treasury Department; Commerce Department

Taxing, of course, does it directly. And it seems logical to ask us to pay for the programs we receive from the government. The problem is—many people seem to think that government money, particularly Federal government money, comes from some mysterious, inexhaustible source, or at the very least, from "the other person." And woe to the politician who is this forthright and suggests raising taxes to pay for increased government spending—as Walter Mondale found out back in 1984.

Borrowing, on the other hand, is more nebulous. As such, it has become the preferred route, witness the spate of budget deficits referred to above. However, besides involving interest costs, borrowing also removes buying power from the private sector as people give up what might otherwise be spendable funds to buy Washington's Treasury bills, notes and bonds. If Washington borrows from abroad, it means not only high interest rates, but a strong dollar as well, with its attendant consequences on trade and our domestic production. And if the government was to borrow from the Federal Reserve, it would lead to the creation of new money, thus the potential for inflation. And inflation, of course, robs *everyone's* dollars of their purchasing power.

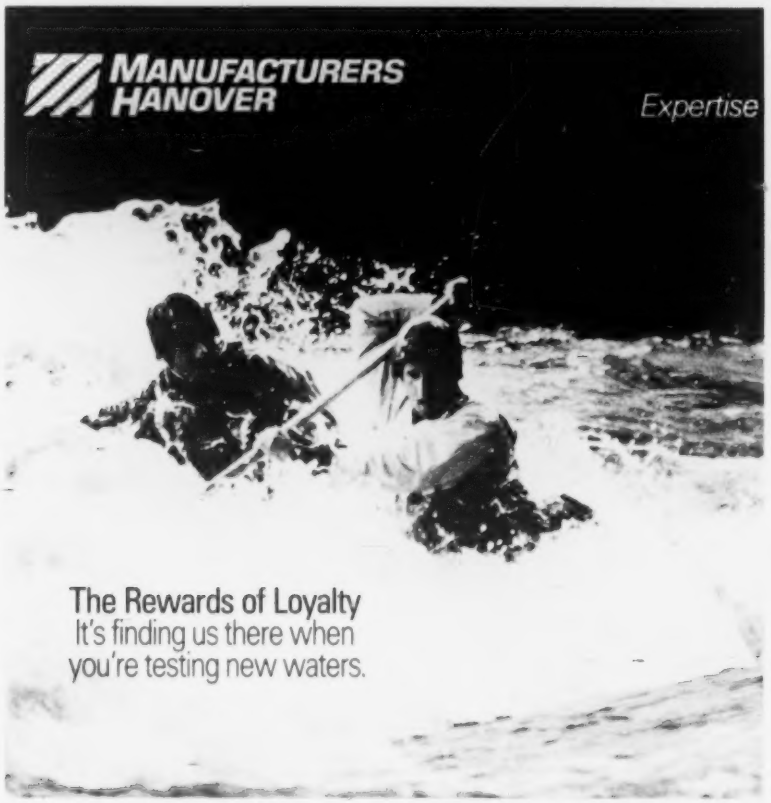
It is to their credit that, in this Congressional election year, the President and leaders of Congress are seriously examining ways to reduce Washington's budget gap—even if it involves raising taxes. Undoubtedly the arguments that this Report and others have been making over the years regarding the visible and less visible effects of the deficit have finally sunk in. While the U.S. economy as a whole is not in a recession, the goods producing sector certainly is, witness the flattening in output, and losses in jobs over the past year and more.

Déjà Vu All Over Again

The old rules of the game would have called for an easing of both fiscal and monetary policy to stimulate business activity. Right now, however, we have the same combination of economic policies we had in 1982: A loose fiscal policy accompanied by a tight money policy. As observed above, we saw eight years ago that big budget deficits and tight money do not mix. The right mix for that era—and this one as well—is for fiscal policy to tighten so that monetary policy can ease.

This prescription should produce lower interest rates. In turn, this would alleviate a variety of ills, ranging from the cost of servicing Washington's debt, to the cost of financing a car or a home. The dollar might even fall as foreigners find rates abroad more attractive than in the U.S., and this, of course, would help our exports while slowing imports.

Once monetary and fiscal policy are in better balance, the economy will be, too. The rules of economic behavior may still change from time to time—but the economy as a whole might well become more manageable—if not more predictable.



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Economic Report

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Economic Report

August 1990

Commentary on Pertinent Economic Issues

Time To Ease

Irwin L. Kellner
Chief Economist

Nearly a quarter of a century ago, it was becoming increasingly obvious that, after years of battling the communists, the United States was slowly sinking into the quagmire of Vietnam. As the search for a face-saving way of extracting ourselves from this situation intensified, Senator George Aiken (R-Vt) came up with an interesting idea, which, if used at that time, might well have saved many lives—not to mention millions of dollars. In a speech on the Senate floor in October 1966, he said that we "...could well declare unilaterally that this stage of the Vietnam War is over—that we have 'won' in the sense that our armed forces are in control..." In other words—we should declare that we won the war and go home.

Today a similar situation has developed which seems to call for a similar declaration. For after years of the Federal Reserve's battling inflation, it now appears that the U.S. economy is in danger of sinking into recession. Indeed, some economists—and quite a few businessmen and consumers—would put it even more bluntly. They point out that, with about half the economy—measured either geographically or by product line—already declining, the threat of a national recession is now the greatest in almost eight years.

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The Fed has been keeping its credit reins fairly snug because of what it believes is an ongoing inflation threat. Yet most of the inflation consumers are confronted with today appears to be in services over which the Fed has little control; prices of many goods have either stopped rising, or, in some cases, are even falling. Thus it would seem that Senator Aiken's suggestion of 24 years ago might be applicable to Alan Greenspan and his colleagues at the Fed: Declare victory over inflation, loosen the credit reins and let interest rates decline.

To be sure, Mr. Greenspan acknowledged last month before several Congressional forums that the Fed has eased its monetary policy. But he pointed out that such a move—which has already shown up in a slight decline in the Federal funds rate—was in response to signs that banks and other lenders were becoming so cautious as to create "crunch"-like conditions for certain types of borrowers in certain areas of the country. The Fed chairman added that he did not believe major easing was necessary at the moment, insisting that he didn't think the economy was all that weak.

From here, it would appear that the evidence suggests otherwise. For one thing, fiscal policy may be on the verge of tightening, as the President and leaders of Congress seriously examine ways to reduce Washington's budget deficit (Economic Report—June 1990). And no matter how the gap is closed—either through spending cuts, tax increases, or both, any significant reduction represents fiscal restraint, for it drains spending power from consumers and business. Since the economy has virtually slowed to a crawl, this tightening is the last thing that's needed—especially in light of the belt-tightening at the state and local levels—unless it is offset by easier money and lower interest rates.

Goods Are Down

Fiscal policy aside, it would seem that easier money is called for because the Fed has won the war against the portion of inflation it is capable of beating—prices of goods. What's more, it has done so by knocking the goods sector—which accounts for more than half of our gross national product—flat on its back. Goods' prices at the consumer level fell in April and again in May, seasonally adjusted, before rising in June. However, on a three-month basis, goods' prices are up only 1.3 percent, compared with the postwar average of four percent—and a three-month jump of 10½ percent earlier this year (Chart I)!

Going back one step in the production process, the Labor Department's producer price index for finished goods is up little more than three percent over the past 12 months; at the beginning of this year, this index's 12-month rise was nearly twice as much. Prices of intermediate goods, a further step back in the production process, have risen only 0.3 percent in the past 12 months compared with 2½ percent six months ago. And at the earliest stage, raw materials, prices are *down* a hefty three percent over the past year; they were five percent

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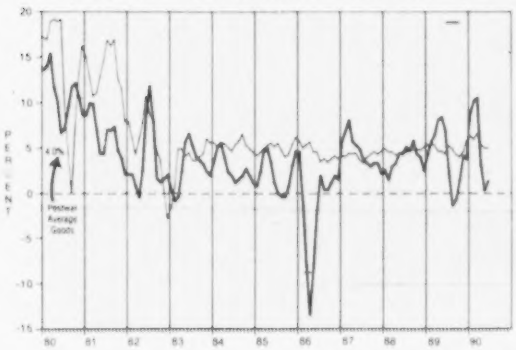
higher, year-over-year, back in January—and nearly nine percent above their year-before levels last November.

CHART I
CONSUMER PRICE INDEX: GOODS (THICK) VS. SERVICES (THIN)
(3-MONTH PERCENT CHANGES AT ANNUAL RATES)



Source: Bureau of Labor Statistics

It's not too difficult to find out why. Goods sales are falling. Before rising slightly in June, retail sales had declined three months in a row—the first time that has happened since the last recession. Second-quarter GNP data reveal that personal spending on goods—one-third of GNP—fell from year-earlier levels. Only twice in the past 45 years has such a full-year drop *not* led to a recession (Chart II). Although most of these declines are in the durable goods sector—mainly sellers of building materials, hardware, garden supplies, mobile home and automotive dealers—quite a few retailers of softgoods are feeling the pinch as well. For example, sales at department stores, apparel specialty outlets, food stores and gasoline service stations are up—but not as much as inflation, according to the Commerce Department.

Not surprisingly, goods payrolls are down. In the past three months over 200,000 people engaged in the production of goods have lost their jobs. With one exception—the three months ending in May of this year—this is the biggest decline for any three-month period since the last recession. Indeed, *all* payrolls would have stopped growing in the past three months, were it not for the decennial hiring of census takers by Washington. To prove the point, the number of nonfarm industries adding to payrolls in June was the smallest in more than 7½ years.

Once again, the goods side is taking the biggest hit. Employment in both durable and nondurable goods industries is down over the past 12 months with most of the Labor Department's major categories coming up negative. As a matter of fact, only three industries—publishing, chemicals and petroleum—added to their payrolls over the past 12 months. Service industries are doing better, although not as good as last autumn, once you factor out the government. One reason is the financial sector. While the banks are still expanding their workforces, they are doing so at a decidedly slower pace than last year—while Wall Street continues to shed employees.

One of the hardest hit areas is construction. In the past 12 months, only 9,000 people found work in this industry; as recently as this past February, the 12-month rise was a healthy 215,000. In view of how sick residential construction is, it would not be surprising if payrolls in this sector were to start shrinking, year-over-year. New-home construction has fallen five months in a row and is currently running at the lowest pace since the last recession. Nonresidential construction isn't doing much better; business real outlays for structures such as factories, office buildings, warehouses and the like at midyear were about the same as they were at the end of 1973—16½ years ago!

People aren't buying new homes for a number of reasons, but the main one is they can't afford them. Today, the average home costs more than four times the average family's income, compared with less than 2½ times 20 years ago, when residential construction was at its peak. And this comparison includes the fact that the average family 20 years ago had one breadwinner, whereas today it's usually at least two people holding down three (or more) jobs. For its part, business spending on structures is being constrained by the low rate of capacity use, and by sluggish profits.

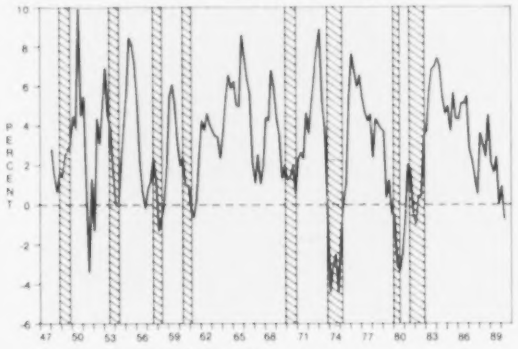
Even export growth, the bright spot in the U.S. economy, is beginning to dim. After logging in year-over-year gains of as much as 30 percent in early 1988, export growth has since throttled back to little more than eight percent. As a partial consequence, factory output's annual growth has slowed concurrently, from nearly eight percent 2½ years ago, to about a sixth as much today.

Services Are Up

When you look at the service sector, however, a different picture emerges, as though the U.S.

economy had a split personality. For service prices are still climbing at an annual rate of 5½ percent. This is essentially the same pace they've been clocked at since the beginning of the current expansion nearly eight years ago. It is nothing short of amazing, considering the ups and downs to which the economy has been subject during this time. It is, however, not all that surprising, once you inspect this sector more closely.

CHART II
REAL PERSONAL CONSUMPTION EXPENDITURES FOR GOODS
(YEAR-OVER-YEAR PERCENT CHANGES)



Source: Commerce Department

For one thing, services tend to be labor intensive. That is to say they require about as much labor per output as they ever have. Several examples would be doctors, lawyers, beauticians, accountants, musicians and teachers. Thus when the cost of these people's efforts rises—and it's been climbing around five percent per year—it's hard for them or their employers to avoid raising prices. These price hikes tend to stick because, unlike many goods, services tend to be necessities, leaving consumers with little or no choice, when it comes to paying the tab.

Take medical care and education. For nearly 30 years, medical services have been rising twice as fast as the overall consumer price index. In the past dozen years, the cost of education has ratcheted up 50 percent faster than the CPI. And let's not forget local governments which add to service inflation when they boost transit fares, tolls on highways, bridges and tunnels, and, of course, taxes. There's no way that the Federal Reserve can prevent these kinds of price hikes—unless it were to become so tight that the current weakness in the goods sector would spread to services, pulling the entire economy into a long and deep recession.

The Fed's Still Tight

Not that the Fed isn't tight already. The recent dip in the Federal funds rate notwithstanding, total bank reserves, the raw material that banks use to make loans and investments, have expanded by only 1.2 percent over the past three years. This is plainly the slowest 36-month rise since the three years ended February 1958 (when the economy was in a recession), and compares with an average 36-month rise of 15 percent over the past 43 years. As a result, the broadest measure of the money supply, M3, is currently growing at its slowest 12-month pace in at least 20 years. This is the major reason why real interest rates (rates adjusted for inflation) remain well above their postwar averages.

These high interest rates are exacerbating another problem faced by consumers, business and governments the world over—huge debt loads. Consumer debts have never been higher, when compared with their incomes, thus their ability to repay. For its part, business in the aggregate must now set aside nearly half its net cash flow just to service its debt. Five years ago, this ratio was only 25 percent.

The jump, of course, reflects the combination of rising debt and falling profits. Earnings are down because companies aren't selling enough to cover their costs, and because they can't raise prices, either. As a consequence, profit margins have fallen almost continuously since 1985, and now stand at their lowest point since the last recession—little more than half their postwar average. Unless this improves, dividend payouts, now historically high relative to net profits, will have to be cut. Considering that price-earnings ratios are already a third above average and interest rates are high enough to be pulling money into bonds, any widespread cuts in dividends would seem to put stocks at risk of a substantial decline.

When Alan Greenspan was President Ford's chief economic adviser, he started a campaign to Whip Inflation Now, and handed out WIN buttons. Maybe it's time for the Fed to move from WIN to LOSE (Lift Our Sluggish Economy) so we can have a DRAW (Deliberate Recovery At Work).

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For Boom The Bell Tolls

Irwin L. Kellner
Chief Economist

For about three years, economists have been scanning the business horizon, waiting for the next recession to come into view. Summer 1987 saw the recession watch begin because the expansion, which was born at the end of 1982, was approaching the previous record for peacetime longevity, and was beginning to show signs of old age. Inflation was picking up, interest rates were climbing, sales of autos and housing were softening, and, of course, the stock market peaked in late August—and crashed in October.

The 26 percent plunge in stock prices in mid-October 1987 brought many forecasters into the recession camp. This is because the only time in this century when a drop in stock prices of this magnitude was *not* followed by a recession was just at the start of World War II. Then, the military buildup more than offset the depressing effects on wealth and confidence that might have arisen from an even greater plunge in stocks. Since we were not on a wartime footing in 1987, it was not unreasonable to expect the negative effects of the market's fall to ripple out, producing the nation's ninth postwar recession.

Today's Troubles Began in 1987

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Obviously, there was no downturn, economy-wide. However, the *beginnings* of one did get underway, which was masked by the sharp drop in interest rates and in many commodities' prices, the quick rebound in stocks, and the surge in exports thanks to the earlier decline in the value of the dollar compared with the currencies of our major trading partners. Nationwide, there was a drop in consumer spending, which led to a decline in output and in goods-producing jobs. New-home purchases were postponed, while business outlays for physical plant dropped to levels first seen in late 1973.

But it was localized developments that were to prove fatal for the aging expansion. Not that different regions hadn't taken hits earlier, without dragging the entire economy down. The Southeast suffered early in the expansion because the Latin American debt crisis, with its attendant currency devaluations hurt foreign buying power. The Farm Belt experienced a couple of bad weather years, while the Oil Patch took its lumps as the price of oil plummeted in late 1985-early 1986. And the Midwest saw its market for heavy industrial goods like steel and automobiles melt away to changes in technology, as well as to foreign competition.

Because these regions did not decline simultaneously, the national expansion rolled on. However, the decline in stocks in October 1987 led to something broader. First, there was reduced trading activity, hence, drops in brokerage houses' and brokers' incomes. Financial industry employment was also affected by the reserving actions taken by the money-center banks that summer because of their developing country debts. The wave of leveraged buyouts led to widespread staff cuts—both among those companies directly involved, as well as by others, seeing an opportunity to slim down. The decline of the junk bond market and tight money slowed the takeover boom, causing many investment bankers to lose their jobs as well.

Blame It On Real Estate

These cuts in the ranks of top professionals, managers and their clerical support staff, had the effect of reducing the demand for office and residential space just as changes in local zoning codes and anticipation of the Tax Reform Act of 1986 had caused builders to hasten the development of many properties. The result was a decided softening of the real estate market, which, although starting in the Northeast, quickly spread across the country. Not only did this slow the construction business—the nation's largest industry—it also began to have a powerful affect on people's attitudes. For unlike stocks, which are owned by only a minority of people, real estate is—literally—closer to home. And the ensuing drop in housing prices, moreso than the plunge in stock prices, convinced people that hard times were at hand.

Not surprisingly, consumers' confidence levels started to erode around two years ago, which, of course, was the major reason for the pullback in spending. They took a header this past August, in response to the jump in oil prices brought on by Iraq's invasion of Kuwait. Business, seeing the sharp drop in retail sales, responded by slashing output and by laying off workers, although not fast enough to prevent

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an unwanted pileup of unsold goods, which, of course, will have to be worked down. New-home construction continued to decline, hitting eight-year lows, with no end in sight, while even exports, until now the bright spot, declined over the summer as Canada, our biggest trading partner, edged toward recession.

In trying to assess whether our own recession has already begun, keep in mind the following:

- Five of the eight postwar recessions started with the real gross national product rising during the opening quarter, so we could well have entered into the ninth as far back as this past spring, when actual sales to final consumers fell for the first time in eight years.

- There need not necessarily be two consecutive quarterly declines in real GNP for a recession to be declared, since two of the eight lacked this "requirement."

No Policy Ease So Far

As far as determining how bad this downturn will be, a look at the posture of economic policy alone suggests it might be worse than average. This is because, for the first time since the 1930s, both fiscal and monetary policies are not easing to cushion the downturn. True, Washington's budget deficit is large. It is approaching a record in absolute terms, and will likely be the greatest, relative to the size of the economy, since 1986. However, the emphasis nowadays is not to ease, which would involve widening the deficit by spending more and/or by taxing less, but, rather, just the opposite! Gramm-Rudman, the Federal Reserve, and the prevailing view in the economics profession all say that Washington's deficit must be reduced, in order to relieve pressures on the financial markets so that interest rates might come down. For its part, monetary policy remains relatively tight—even though a recession might well have gotten underway nearly a half year ago—as Fed Chairman Alan Greenspan remains concerned about the lack of a budget agreement, not to mention today's high rate of inflation.

On the fiscal side, this Report has, for years, been calling for deficit reduction, so it may come as a surprise to the reader that, at this time, caution should be the watchword. From here, it would appear that we lost the opportunity to make major cuts in Washington's deficit when the expansion fizzled out. Now that the economy is declining, to make wholesale cuts in the deficit by either cutting spending and/or by raising taxes would only push the economy down even more.

Under these circumstances, lower interest rates, whether fostered by the Fed or by the markets, themselves, might not be of much help. As we learned during the 1930s, easier money does not by itself boost economic activity. As the economy spiraled downward into what came to be known as the Great Depression, the Fed flooded the banking system with reserves, hoping to drop interest rates down low enough to stimulate the borrowing necessary to increase spending. Rates came down all right, but the banks refused to lend and people were reluctant to borrow. This gave rise to the expression, "You can't push on a string."

In some respects, we are in the same circumstances today. The deflation of many asset values, such as real estate, along with huge debt loads now being borne by consumers and corporations and the contraction of the junk bond market, has begun to affect attitudes toward debt on the part of both borrowers as well as lenders. Total consumer debt outstanding now equals a record 85 percent of take-home pay, while America's nonfinancial corporations must now set aside more than 35 cents out of every cash flow dollar just to service existing debt—nearly twice the level of five years ago.

Lenders, naturally, have become more reluctant to extend credit. Many banks and thrifts have experienced significant increases in problem loans, while others are being told by their regulators to boost their capital ratios. Both have led in the same direction: lending cutbacks, often referred to as a credit crunch.

Not that the Fed appears to be in any great hurry to ease. Even though the Federal funds rate has come down a point over the past year, most money and credit aggregates still show little growth. Besides waiting for a credible budget agreement, Fed Chairman Greenspan is also waiting for inflation to subside. He may have a long wait. Besides the price of oil, inflation is also being pushed up by services such as medical care and education, over which monetary policy has little, if any, control (Economic Report—August 1990). Most nonenergy goods' prices are rising only slowly.

The Fed also seems to be taking its cues from the bond markets. When the funds rate was dropped slightly in July, bond yields went up, as fixed-income investors became concerned that

the Fed was "caving in" to inflation. Since then, Fed officials have referred to the possible reaction by the bond crowd to monetary and other developments. This is too bad, since the markets need to take their direction *from* the central bank, not the other way around. Anyway, bonds will be under pressure for some time to come because of the huge borrowing needs Washington will have regardless of how the deficit reduction talks are resolved, not to mention reduced purchases of Treasury securities by investors from overseas.

Having said this, it would not be good from the economy's long-term perspective if the Administration and the Congress were to use the current economic downturn as an excuse to abandon the deficit reduction process altogether. There is no question but that the economy's long-run state of health requires a closer matching of revenues with spending, and a reduction in Washington's outstanding debt—at least relative to the size of the economy. However, in today's context, the deficit reductions should be concentrated in the "out" years, or years beyond fiscal year 1991 which began October 1, rather than in the near term. A sliding scale of deficit cuts once the economy strengthens would seem to be a better way of reaching the President's goal of cutting $500 billion over five years than simply taking the same amount out of each year.

Some Bright Spots

To be sure, all is not bleak—economic policy notwithstanding. For one thing, consumers' attitudes may brighten when they see that their worst fears may not be realized. It would appear that confidence plunged in August because people have vivid memories of what happened twice before, when a Mideast crisis boosted oil prices. Not only was there a flareup in inflation along with soaring interest rates and a subsequent recession—there were also long lines at the gasoline pumps. This last development is unlikely to occur this time around because the government is out of the picture. There are no longer any Federal controls on oil and gas prices, nor is Washington telling the oil companies where to ship their products.

Inflation is unlikely to worsen beyond a brief blip for a month or two as happened last winter, when extremely cold weather caused demand for heating oil and natural gas to soar, and with it, their prices. First, the economy is too weak to allow business and consumers to pass these costs along. Second, money is tight, meaning that there isn't enough liquidity to support a generalized round of price hikes.

Then there's energy efficiency. Transportation, the biggest user of oil, has become significantly more efficient. The average passenger car on the road today gets over 21 miles per gallon—a 60 percent improvement from when the first oil crisis struck. Electric utilities, which require a growing share of the energy used in this country, now derive less than five percent of it from oil, compared with four times as much 17 years ago.

We're unlikely to catch the inflation virus from abroad, either. Other Western countries are even more energy efficient than we are—and their currencies have risen against the dollar so they won't have to pay much more for oil, which is sold for dollars. Another moderating influence on the recession might well be the after-effects of the Mideast crisis, itself. For one thing, defense outlays might not be cut as much as planned, giving a lift to those parts of the country and those industries that depend on military spending. This will create new jobs besides these made available by the callup of the reservists.

Then there's the impact of the jump in petroleum prices. When oil was priced in the mid-teens, the industry found it uneconomical to drill for more. Now that it has reached into the upper 30s, it has become much more worthwhile to search for oil on land, offshore, and from such sources as tar sands and shale. Look for intensified efforts to find and use oil substitutes for transportation, as well as for generating light, heat and energy to turn the wheels of industry. Coal, geothermal, nuclear and solar power are some of the methods that will attract investment capital, thus becoming a prop under economic activity.

Of course, the need to conserve energy will add to business as well. Expect increased efforts to use computers to design buildings and automobiles, meter out gasoline, turn on and off lights and run machinery more efficiently. Anticipate, also, that demand for insulation, storm windows, and other energy-saving devices will increase. Indeed, the business of finding and saving energy will once again move to the forefront of top-performing industries. When added to public construction, waste management and health care, you can see the potential for keeping this recession's economic damage to a minimum.

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